STATE OF CALIFORNIA

Department of Housing and Community Development
Community Development Block Grant Program
Economic Development Allocation

REVOLVING LOAN FUND HANDBOOK

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INTRODUCTION

PURPOSE OF MANUAL

This manual is designed to assist in the implementation, management/ and administration of an economic development Revolving Loan Fund funded through the State of California, Department of Housing and Community Development (HCD), Small Cities Community Development Block Grant Program (CDBG). This manual should be used in conjunction with the current **State Community Development Block Grant Program - Grants Management Manual** and communities should refer to their own program guidelines and policies for grant management and loan policy issues. This manual does not address other eligible economic development activities such as Public Infrastructure Improvements or Microenterprise Assistance. These activities are discussed in application training manuals and other State CDBG materials. [See Exhibit A for a listing of reference materials.]

BACKGROUND AND CONTENTS

The Revolving Loan Fund program (RLF) is a business development program that allows loan repayment moneys to be "revolved" or recycled and made available for future economic development projects. Under this State of California economic development program, communities capitalize revolving loan funds in two ways: 1) Directly under the California Community Economic Enterprise Fund; and 2) Indirectly through capturing of repayments from loans made by the community through the Over-the-Counter Program (under the jurisdiction's Program Income Reuse Plan approved by the Department).

This manual suggests ways to minimize losses through effective portfolio management including origination of quality loans, sound closing practices and ongoing servicing practices. The manual will take you through the steps to creating and administering a revolving loan fund through the following sections:

I. Program Design
II. Implementing Program Design
III. Identification and Screening of Applicants
IV. Loan Application Process
V. Loan Closing and Disbursement
VI. Loan Servicing and Monitoring
VII. Appendix

I. PROGRAM DESIGN

ASSESSING THE COMMUNITY’S NEEDS

The first step in designing your revolving loan fund is to assess the community’s need for the RLF. Are there unmet credit needs in the community? If so, what are they? Can the RLF be structured to address these needs? Because there is a limit to the capital available, most RLF’s are designed to assist small businesses rather than to attract larger businesses such as Fortune 500 companies, since the RLF can have an impact with smaller firms. Small businesses, unlike many larger corporations, inherently suffer from a lack of access to attractively-priced, long-term financing. Economic development programs such as a local RLF are typically designed to bridge that gap.

A goal of the RLF should be to leverage private sector dollars in order to expand the amount of capital available to small businesses. A successful RLF requires a public/private partnership to provide community leadership, direction and control. The local RLF should strive to complement rather than compete with existing private sector financing. Local private sector lenders should be the RLF’s most valuable partner in the program and getting these lenders to support the program will be critical to the success of the RLF. The RLF provides incentives to lenders (guarantees and collateral cushion subordinated liens), that increase their ability to make loans to smaller businesses in the community.

To determine unmet credit needs in the community, the local government should meet with all interested parties to discuss local financing needs of small businesses. Members of the business community, private sector lenders, equity investors, chamber executives, economic and community development professionals, and technical assistance providers should be asked to contribute their ideas to the creation of the RLF. From this partnership, an RLF that helps meet the credit needs of the community can be created.

MAXIMIZING THE BENEFITS OF THE PROGRAM

In designing the program, the major economic and business characteristics of a community should be evaluated. This includes existing economic conditions, other available financial resources, expertise available locally, and local community interest in economic development efforts. Once a community has examined its specific strengths and weaknesses, it must then consider all of the RLF alternatives: business eligibility criteria, financing methods, leverage, uses of proceeds, terms and conditions, collateral and general administration. In most cases, the needs identified will dictate the program design choices.

Revolving loan funds are a useful tool for economic development. Economic development programs that target business expansion and retention or the attraction of new businesses require an available source of affordable financing. A Revolving Loan Fund can provide this, but it is important to be realistic when designing your program. RLF resources are scarce compared to capital in the private sector and they will not provide the answer to all unmet credit needs in the community. Decisions must be made as to where to target this limited resource. It is not a panacea.

In terms of eligibility, a community may want to target the program to only small businesses, or manufacturing concerns, or businesses located in a specific area, such as a downtown. The community may choose to focus on existing businesses over start-up businesses since existing businesses have a track record on which to base a credit decision and the evaluation of a start-up business is much more difficult and requires the RLF to consider a significantly higher level of credit risk. There are many choices to be made. However, it is important to keep in mind that, when CDBG funds are used to assist a private for-profit business, there must be a determination that public benefit in the form of job creation or job retention will result. Given this requirement, CDBG-capitalized RLFs are really job-based assistance programs. In addition, the CDBG loan must result in meeting a CDBG national objective which means that a CDBG RLF’s principal mission is typically to create or retain jobs that principally benefit qualifying low- and moderate-income persons.

STRUCTURING THE RLF

Direct Loans. There are three basic of ways to structure an RLF loan. The first method is to provide a direct loan to a business. The direct loan can range from a small portion of the total project cost to 100 percent of the project. The most popular structure is where the RLF only provides a portion of the total loan and private sector financing and equity provide the greater share. This is called a companion loan. Usually the RLF will take a subordinate collateral position to the private lender. The advantage of the companion loan structure is that the RLF loan is leveraged and credit risk is shared. Direct loans generally require more staff resources to originate and service than do the loan guarantees or participations described below.

Loan Guarantees. RLFs can also be used to guarantee loans. The RLF dollars are pledged to secure loans made by a private sector lender. Typical guarantees are from 75 to 90 percent of the loan amount, but the amount of guarantee should be informed by an analysis of the risk to the lender. The advantages of the loan guarantees include: minimal capitalization, maximum leveraging of funds, and risk sharing.

Loan Participations. Participation in another lender’s loan is a third way the RLF can leverage its dollars. Under a loan participation, a bank or other lender makes the loan, services the loan and does all of the related paperwork. The RLF participates by providing dollars to the bank for the loan or, in essence, “buying” a piece of their loan. The RLF is repaid by the bank as payments are made to the lender. Using the participation structure is often easier because it requires minimal staff and reduces risk, because the private sector lender does the work and acts as the underwriter. The disadvantage is reduced involvement and, hence, control over such things as project structuring and underwriting, and program marketing.

STAFFING THE PROGRAM

The level of sophistication and experience of the RLF staff must also be considered when designing and structuring the RLF. The community may need to hire and train capable RLF staff. Usually a small (one to two person) staff which is self-starting and results oriented is adequate. Relying on part-time staff or staff dedicating only a percentage of their time to the RLF will not likely result in satisfactory results.

The RLF staff will be responsible for marketing the program; building relationships; screening, structuring, packaging, closing, and servicing loans; and disbursing funds. A lending or finance background is helpful, but in-house or outside training may be considered for otherwise qualified individuals. Continual training should occur to improve the skill level and motivation of staff.

Jurisdictions that lack in-house expertise, but do not want to add staff to implement the program, can contract for services with an experienced non-profit or for-profit organization. To help insure the program's success, the jurisdiction should be certain to contract with a program operator that has a successful track record of implementing a business revolving loan fund program consistent with CDBG requirements. Exhibit G provides a matrix of typical tasks that must be completed during implementation of a CDBG-funded RLF and should be consulted when developing the scope of work that will be assigned to a contractor. The jurisdiction is subject to CDBG procurement requirements when procuring professional services. See Exhibit F for sources of information that should be consulted to insure compliance with CDBG procurement requirements (and other federal overlay requirements).

II. IMPLEMENTING THE DESIGN

THE MISSION STATEMENT

A successful revolving loan fund begins with a clear and well-defined purpose or mission statement. Each community will want to define the purpose or mission of the RLF to meet its particular needs and objectives. An examination of needs and objectives may be found in a locality's existing local plans such as a locality's special plan or Overall Economic Development Plan. From the missions statement, RLF staff should be able to determine whether a proposed loan meets key criteria (location, size, or type of business, number or size of jobs created or retained, etc.). For example:

> The Sample City Revolving Loan Fund was created to expand job opportunities for low income persons in the community by assisting local businesses in generating and creating capital.

GOALS AND OBJECTIVES

The next question which must be answered is how will the RLF accomplish its mission. In general, the goals or objectives of a Revolving Loan Fund Program are threefold:

First: To make adequate and affordable credit more readily available to successful small businesses which will create and/or retain jobs in the community.

Second: To encourage and to maximize, through public-private partnerships, the participation of local commercial banks and other private sector lenders and investors by providing gap financing to small businesses.

Third: To provide technical assistance to business owners to strengthen their financial, management, and technical skills.

Adequate and Affordable Credit. Through the program, communities will be able to assist lenders in extending credit to small businesses which is more affordable to the business and less risky to the lender.

Maximum Private Sector Participation. The RLF is not a substitute for or competitor to your local banks. The RLF is in partnership with local banks and private investors to collaboratively make credit more readily available to businesses in the community. The RLF will not make bad loans. It will make loans to viable businesses which may not be bankable conventionally, and it will structure its financing in a manner which encourages expanded lender participation.

Technical Assistance. The RLF administrator can identify the technical assistance needs of small businesses and provide linkages to technical assistance providers. After a review of a company's financial condition, the applicant should be referred to the appropriate technical assistance program, such a small business development corporation.

LOAN POLICY AND PROCEDURES

Once an RLF has been designed, and its mission, goals and objectives have been clearly defined, a formal loan policy must be adopted. A sample loan policy is included as Exhibit A This policy should be reviewed annually and updated as the needs, goals and objectives of the community change. Generally, the loan policy will lay out the parameters of the program adopted to meet the community objectives. The amount of risk taken by the community in its lending practices should be weighed against the public benefit. The following should be considered when adopting a formal loan policy:

1. **Eligible Borrowers**. Since a primary objective of the revolving loan fund program is to make affordable credit more readily available to small businesses with unmet credit needs, the businesses assisted should at minimum meet the following criteria:

    - It is located within or expanding to the participating community’s jurisdiction;
    - It can demonstrate a high potential for success;
    - The project requires RLF participation to go forward;
    - It will create public benefit through employment opportunities within the target area for the targeted income group;

- The owners have committed or will commit time and capital to the business; and
- There is a reasonable possibility that the RLF will recapture its investment.

Loans to start-up businesses inherently represent a higher risk and, therefore, a higher rate of loan default. A community may choose to take a higher risk to achieve its stated community objectives. However, a mix of loan types within a fund is most common. For example, an RLF may entertain some loan requests from start-up businesses, but may have approximately 80 percent of its funds earmarked for existing, active businesses who have a successful track record of more than one year. Start-ups must demonstrate adequate capitalization and sound management if they are to be considered.

2. **Acceptable Loan Loss Rates**. Traditionally, commercial banks expect a one percent annual loss rate on their commercial and industrial loan portfolios. From the description of the types of companies the RLF will finance, it is obvious that the RLF loans will have somewhat less collateral and somewhat more risk than conventional lenders’ loans. The RLF should consider an annual loss rate of ten percent or less as a target, depending on the public benefit analysis.

Losses are principally a function of two factors: 1) credit criteria and 2) loan servicing and work out procedures. The RLF must adopt credit criteria and servicing procedures which will keep loss rates acceptable. Where credit criteria is concerned, the RLF will be making loans to businesses which have demonstrated the ability to generate cash flow, but may have somewhat weaker collateral than conventional borrowers. In addition, loans to start-ups should be limited. Where loan servicing is concerned, the RLF should implement an intensive servicing system [see Exhibit B, Servicing and Documentation Requirements] which will minimize delinquencies.

3. **Job Creation/Retention**. The primary goal of the Revolving Loan Fund Program is to assist businesses that will create new jobs and/or retain existing jobs in the community. The RLF should attempt to make loans where the funds create and/or retain the maximum number of jobs for the least amount of RLF investment. Businesses receiving RLF loans must also be willing to give the targeted income group priority in hiring.

4. **Eligible Use of Proceeds**. The project must be commercial (retail, wholesale, and service) or industrial. RLF funds can be used for the following:

- land costs, including engineering, legal, grading, testing, site, mapping and related costs associated with the acquisition and preparation of land;
- building costs, including real estate, engineering, architectural, legal and related costs associated with acquisition, construction and rehabilitation of buildings including leasehold improvements;
- working capital, inventory, furniture, fixtures, machinery and equipment.

RLF funds may be used to assist a business in financing accounts receivable and inventory. However, the RLF should consider having a commercial lender involved in financing or servicing a line of credit for this type of business credit need. When using this type of financing mechanism, the RLF program must ensure that jobs are being created as a result of this financing. Financing lines of credit involves more borrower oversight and more intensive loan disbursement procedures because funds are disbursed on a need basis against a base percentage of receivables.

5. **Ineligible Use of Proceeds**. Loan proceeds may not be used to reimburse an applicant for costs incurred prior to submission of an RLF loan application. Residential projects are ineligible. Other costs which the RLF may want to limit or make ineligible include the following:

- product development costs;
- organizational costs of a start-up;
- investments in real estate held for investment purposes;
- distributions or payments to owners and shareholders;
- finders fees for securing financing;
- payment of delinquent taxes; and
- providing more than 25 percent of loan proceeds for refinancing existing debt.

6. **Loan Amounts**. The RLF may make loans of any size (subject to the availability of funds; however, a community may want to consider minimum and maximum size standards). Ultimately, the size of a particular loan

is limited by the amount of public benefit that is projected by the business at the time CDBG assistance is provided.

7. **Leveraging.** The RLF should strive to maximize leveraging of its capital through the participation of other lenders and other investors, but the participation of other lenders is not necessarily a requirement. However, equity is a form of leverage and should be present in every project.

8. **Equity.** Almost all projects require some equity from the applicant business - a minimum of ten percent is standard. For business start-ups or buyouts, the RLF may want to consider a higher equity participation, e.g., from 15 to 25 percent. The RLF may want to allow the borrower to meet an established equity requirement through methods other than through cash contributions. For example, if an applicant has purchased land and is planning to finance a building on the land as part of its expansion project, the land may be considered equity in the project. If equity is not provided in the form of cash, a method for valuing the "equity contribution" from additional pledged collateral pledged should be adopted [see Collateral Policies under Section IV]. The RLF should remain focused on the reason for requiring equity in a project -- to ensure the borrower's financial commitment to the success of the project. When evaluating equity, the RLF should ask the fundamental and very important question: "What does the borrower stand to lose if this project is not successful?"

9. **Rates of Interest.** Interest rates for RLF loans are typically at or below the rates charged by commercial lenders for similar loans; the lower interest rate is required to make the project viable [see Exhibit A, HUD Underwriting Requirements]. Bank loans typically have interest rates which are variable or adjustable. The interest rate for the RLF loan should be determined by the need of the particular applicant and the gap analysis. The RLF should consider fixed rate loans as a means of protecting the affordability of the RLF loan.

10. **Terms of Loans.** Typical RLF loans will extend terms from three to 30 years, based on the life of the asset being financed. Working capital loans generally have a term of three to seven years, the typical loan for machinery and equipment is five to ten years, and

real estate loans range in term from ten to 30 years. Most loans are structured with a self-amortizing, fixed repayment schedule. Where the term of the loan exceeds the useful life of the asset being financed, the RLF will need to document the "appropriateness" for the extended term [see Exhibit C, HUD Underwriting Requirements].

11. **Closing Costs and Fees**. The borrower should be responsible for all costs incurred by the RLF for originating and closing the loan, including legal costs, lien searches, appraisals, and credit reports.

12. **Collateral and Personal Guarantees.** As a general policy, each loan should be secured by collateral adequate to safeguard the RLF. When the RLF is the sole lender in a project, the RLF should require a first security interest in the assets being financed and any related collateral. When the RLF is participating with a bank or other lending institution, the RLF may take a shared first position on the assets being financed or it may subordinate its lien position (take an inferior lien position) to the bank. In addition, the RLF should normally file a general security agreement on all assets of the company. Liens on other borrower assets should be required where appropriate to safeguard the RLF. When real property is taken as collateral, the RLF would, in most cases, require an appraisal.

Finally, the RLF should consider requiring personal guarantees for each loan. The personal guarantee may be collateralized with personal assets where available. It is prudent to require hazard insurance on the business being financed and life insurance assigned to the RLF on the principals of closely held corporations or sole proprietors.

The RLF should endeavor to secure each and every loan with adequate collateral, but the lack of hard collateral, by itself, should not be a reason to decline a loan. Many small businesses tend not to have hard collateral on their balance sheets. Their primary assets are their human resources and their receivables. In situations where company operations are healthy and cash flow is relatively strong, collateral is of secondary importance. The RLF's projected loss rate will be higher than a conventional lender's loss rate, in part, because the RLF anticipates low recoveries when moving against the collateral of a small business.

13. **Personal Credit Evaluations**. A business loan is repaid as much from the personal fortitude and integrity of the entrepreneur as from the financial strength of the business. For this reason, the credit history of each entrepreneur should be carefully evaluated. If an entrepreneur has not handled his/her personal obligations to others in a satisfactory manner, he/she probably will not handle the RLF obligation any better. The RLF should request a personal financial statement and perform a personal credit check with each loan application. Credit reports should be satisfactory, meaning the essential bills, i.e., mortgage, rent, utilities, and taxes should be current. Problems in slow payment of revolving credit should be explained by the borrower and no charge-offs should be noted. If substantive problems exist, a satisfactory resolution or a satisfactory explanation of the problem must occur before the loan can go forward. For the RLF lender, credit reports may often be difficult to decipher. The RLF lender is encouraged to seek the assistance of the company providing the credit report to accurately interpret the information.

14. **Application Procedures and Approval Process**. Applicant borrowers may be referred by a local lender or be originated directly through RLF marketing efforts. RLF staff should assist each borrower to complete the application package [see Exhibit F, Loan Application Forms]. The RLF staff should review the application for overall policy and eligibility compliance, as well as general credit-worthiness and provide the Loan Advisory Board (LAB) with a staff recommendation. All projects meeting the established eligibility and credit criteria should be submitted to the LAB for consideration.

The LAB should reach one of four decisions:

- defer the application until the next meeting;
- reject the application;
- send application back to applicant with conditions for further consideration; or
- refer to the City/County staff with recommendations for approval, or conditional approval.

These actions are discussed further in Section IV. All approvals should be in writing and should outline the terms and conditions of the loan and establish a closing deadline. Turnaround time from the point at which an application is complete to closing should not exceed six to eight weeks.

The major purpose of the LAB is to be proactive and to assist RLF staff in making loan applications "bankable," that is, to find a way to structure the deal so that it has a high potential for repayment. If a deal shouldn't go forward, the LAB members should use their credit experience to decline the application. The LAB should meet as often as necessary to be responsive. For each project, staff should prepare a presentation for the committee, outlining the business, the loan request, and the credit history as well as an analysis of the loan request under HUD underwriting guidelines [see Exhibit D, Loan Application Forms and Exhibit C, HUD Underwriting Guidelines].

15. **Conflict of Interest.** No member of the LAB, their immediate family or employer, or the RLF staff, their immediate family or employer; should have any financial interest in businesses receiving loans from the RLF. Any project which creates a conflict of interest is ineligible. (RLF lenders are encouraged to contact their Economic Development Representative concerning Conflict of Interest questions.)

16. **Loan Commitments.** Upon approval, the RLF staff should notify each applicant in writing, listing the terms and conditions of the approval. Loan commitments [see Exhibit D] should be issued within 72 hours of Board approval. Loan commitment letters should be reviewed by legal counsel and signed by the City Administrator, County Administrative Officer, or their designee (by resolution).

17. **Loan Closings and Standardized Documents.** To be a cost-efficient program, the RLF should endeavor to make use of standardized documents and closing procedures. Exceptions should be made as appropriate. Prior to closing, all completed documents should be reviewed for the jurisdiction by an attorney with loan closing experience. Loan documents will be executed by the City Administrator, County Administrative Officer, or their designee. [See Exhibit E, Direct Loan Documents.]

18. **Disbursement of RLF Funds.** CDBG funds should be disbursed on an "as needed" basis and not in a lump sum disbursement unless business will expend the funds

within 30 to 60 days. [See Exhibit O which describes the federal policy governing disbursement of CDBG funds.] The RLF needs to insure that funds are being expended on a timely basis and for the intended costs. For example, loans used to purchase machinery and equipment or to fund leasehold improvements should be disbursed as two-party checks, issued to the vendor and the business.

19. **Credit and Legal Files.** Each loan should have a credit and legal file and “tickler” system for updating the files as necessary. RLF staff will be responsible for keeping the files adequate and current. The information contained in the credit file should be considered confidential in nature while the information in the legal file is generally considered public information. Separating the information in this manner will facilitate open records requests, but the RLF administrator should consult legal counsel before releasing any information to a third party.

20. **Servicing Policies and Procedures.** Two factors help keep credit losses low in small business lending: a prudent set of credit policies; and a timely, personalized servicing system. Servicing procedures are outlined in detail in Section VII, Loan Servicing and Monitoring. Loan repayments may be collected by a bank and the payments forwarded to the RLF staff. The RLF staff should perform all other servicing activities. In most cases, the loan packager who packages a loan should be responsible for servicing that loan. This servicing policy has two beneficial effects. First, there is a continuity in the borrowing relationship. A borrower is less likely to default on a payment to a "friend," someone who helped the borrower get the loan in the first place. Second, there is the pride factor. The loan packager will not want to see one of his/her deals go bad.

RLF servicing should be intensive in order to establish a good payment discipline. Unfortunately, too often in RLF’s, borrowers think the “government loan” really does not have to be paid back, especially if there are other demands on cash flow. An early warning system should be established so that the servicer knows within two weeks that a loan payment has been missed. The servicer should visit all delinquent borrowers within two weeks of notice of the missed payment. Delinquent borrowers should then be visited as often as necessary to reestablish timely payments. The goal of each visit should be to bring back a payment. The borrower should be encouraged to make partial payments if the entire payment cannot be made, with additional installments collected on a weekly basis if necessary. The goal of an intensive call program is to prevent a borrower from becoming so delinquent that he/she feels as though it is impossible to catch up.

21. **Workouts.** The primary purpose of the CDBG RLF is to create or retain jobs. If a restructuring of the CDBG will result in sustaining jobs over the long term, then restructuring the loan is an appropriate work-out strategy. To be a serious loan program, problem loans must be dealt with quickly and fairly. Foreclosure and moving against personal guarantees cannot be idle threats. Problem loans should be referred to the Loan Advisory Board for their guidance and advice. As part of a workout strategy, partial moratoriums may be permitted, but full moratoriums should be discouraged because full moratoriums lead to bad habits (not making loan payments).

III. IDENTIFICATION & SCREENING OF APPLICANTS

HOW TO IDENTIFY POTENTIAL BORROWERS

In marketing the RLF Program it is important to target those segments of the business community most likely to provide eligible RLF applicants. In presentations and supporting materials it is necessary to clearly and plainly state the goals of the program and its eligibility requirements. Be brief. Don't bog down in too much detail. A brochure and a presentation outline are valuable supporting materials.

WHO ARE POTENTIAL BORROWERS

Any business that is currently operating or intends to locate in the community is a potential candidate for this program. The RLF, depending on how it is structured, can be open to all sizes and types of businesses. Additional criteria that the business must meet under State and Federal requirements are summarized in the Verification of CDBG/RLF Eligibility process under Section IV. LOAN APPLICATION PROCESS. In addition, each jurisdiction may have its own local criteria, such as location in a redevelopment area or Enterprise Zone.

SCREENING POTENTIAL BORROWERS

Not all loan inquiries result in applications and not all applications result in loans. A potential project may be ineligible for the RLF Program or the potential borrower may not pursue the project or funding application. Effective screening is necessary and the following techniques can improve the efficiency of the screening process:

- Integrate marketing and screening
- Focus on essential issues

Integrate Marketing & Screening. It is important to coordinate the marketing and screening efforts. The marketing activities will be focused on presenting the program in the most positive way. The purpose of the screening is to encourage and identify those who are eligible and to refer those who are not eligible to other sources for assistance. Marketing staff, if separate from the RLF loan staff, needs to have a good grasp of the basic program requirements so that all potentially qualified businesses have the opportunity to apply.

Focus on Essential Issues. Identify the potential eligibility of a project quickly by asking precise, direct questions. The questions do not require significant detail, but should quickly establish whether or not the project may be eligible for the RLF.

Ask questions about:

- Willingness to screen, hire, track and report on TIG jobholders;

- Background of the business (size, years in existence, principal line of business, etc.);

- The nature of the proposed project (start-up, expansion, etc.) to determine if it is eligible for RLF funds;

- Amount and type of assistance requested. This will illustrate how informed the inquirer is about the nature of the RLF Program and its requirements; and

- Which bank (if any) has provided or is willing to provide assistance to the venture. Conversations with other lenders will provide insight on the credit-worthiness of the business.

If this initial screening process is followed, the decision to decline a request can be reached with the least possible amount of analysis. It saves valuable time to the RLF as well as the business. If the decision reached is to decline the request, it should be communicated to the applicant as precisely and politely as possible. Most applicants will appreciate a professional refusal which explains exactly what must be done to qualify for financing. A weak reply may create false expectations for the applicant. Staff may still be able to assist the applicant by referring them to another lender or a technical assistance provider.

If the project sounds promising, the next step is to accumulate information on the principals, their company, and to schedule an interview with the applicant. This begins the loan application process.

IV. LOAN APPLICATION PROCESS

Once an applicant has been identified and the initial screening of the applicant indicates likely RLF eligibility, the **LOAN APPLICATION PROCESS** should be initiated. The following steps are generally referred to as the Loan Application Process:

- Schedule interview and request preliminary information;

- Interview applicant and determine CDBG/RLF eligibility;

- Applicant submits formal loan application and any additional documentation;

- Conduct site visit and follow-up interview;

- Verify CDBG/RLF eligibility through HUD underwriting procedure;

- Perform detailed financial analysis and classify loan;

- Prepare loan report for staff recommendation to Loan Advisory Board;

- Loan advisory board evaluates loan report and application; and

- Notify applicant of decision and, if approved, terms and conditions of loan, closing procedures and timing.

SCHEDULE INTERVIEW AND REQUEST PRELIMINARY INFORMATION

After an applicant and project have been identified, the loan application process should be initiated. Applicants should be encouraged to bring documentation on the company and its principals.

For existing businesses, required documents should include the following:

- Short description of management, business history;
- Firm project costs (land, building, equipment, soft costs, working capital);
- Last three years’ financial statements on the company (audited, if available);
- Last three years’ tax returns on the company;

- Personal financial statement of owner(s); and
- Personal tax returns - owner(s).

For start-ups and businesses with less than three years of actual operations, required documents should include the following:

- Historical financial statements (to the extent available);
- Business plan, marketing plan, and detailed resumes of management;
- Proforma financial projections for next two years with detailed assumptions;
- Personal financial statement of owner(s); and
- Personal tax returns - owner(s).

In many instances the applicant may be reluctant to provide all the documentation requested at the initial interview. This should not prevent the initial interview from taking place; however, the applicant should be informed that the process will not proceed until the information requested is provided. A cursory analysis of this preliminary financial data will establish potential weaknesses that must be overcome for the project to move forward.

INTERVIEW APPLICANT

When interviewing the applicant, the RLF staff should ask specific questions such as those listed below. The RLF lender should also encourage the applicant to talk about the business, its history, his or her management experience, and what the proposed financing will enable the company to accomplish.

Information on the applicant

- What is applicant’s legal name? Trade name?
- Is the legal entity a corporation, proprietorship, partnership?
- Where is it located?
- What product is sold?
- How long in business?

How much do they need to borrow?

- Is there a bank willing to participate?
- Is equity for the project available? From what source?

- Are there other sources of funds?

The purpose of the loan

- What are project costs?
- How will the proceeds be used?
- Is the purpose eligible for CDBG funding?
- Will the project meet the Public Benefit requirement?
- Does the purpose comply with the jurisdiction's loan policy?

Ability to repay

- Can the applicant provide a specific source of repayment based on reasonable assumptions?
- What is the secondary source of repayment if the primary source fails?
- Are guarantors available? If so, how are they related to applicant?

Amount and terms requested

- How was the amount requested determined?
- Have all financing needs, including working capital, been included?
- Are the interest rate and loan term reasonable?

Collateral availability

- What collateral is offered?
- How attractive is the collateral?
- Is it controllable?
- What is the resale value?
- Can it be insured?

Basic Financial/Company Information

- What were sales for last fiscal year?
- Is the business profitable?
- Does the business have a positive net worth? Is there subordinated debt?
- Number of Employees: now and with expansion?
- What is the ownership structure of the business?

Does the business need technical assistance?

- Marketing?
- Business plan?

- Production?
- Financial?
- Management?

After the initial interview, the RLF staff should have a general sense of how to proceed with the applicant's request. The application should either go forward, be declined, or be referred for technical assistance. In some cases, the basic request is eligible and the credit looks good, but the project needs some restructuring for the application to be considered. In any case, if the application is to move forward, the RLF staff will need to gather additional information from the applicant. The project's eligibility for CDBG funding must also be determined.

DETERMINE CDBG/RLF ELIGIBILITY

Loan Administrators must demonstrate that a potential project is eligible for assistance through the CDBG program. (Program requirements are found in federal and state statute, regulations, and HUD guidelins. See Exhibit F for references and citations.) The following questions must be answered:

- Is the proposed project an eligible use of CDBG assistance?
- Does the project meet the CDBG national objective requirement of benefiting low and moderate income persons?
- Is the amount of assistance requested "appropriate", under the HUD underwriting guidelines and given the level of public benefit?
- Will the project be feasible under other program requirements (e.g., labor standards, environmental review, Uniform Relocation Act, etc.)?

Is the Proposed Project Eligible for CDBG Assistance? If the RLF loan is made to a business to carry out an economic development project, this is an eligible project as specified under federal statute and regulation [See Exhibit A for references to regulatory and technical assistance documents.]

Does the Project Meet a CDBG National Objective of Benefiting Low and Moderate Income Persons? If the project will principally benefit low and moderate income persons (also called the "targeted income group" or "TIG") through job creation/retention, the project will meet the low/moderate national objective. While other criteria exist for assessing activities that benefit low and moderate income persons, the intent of the State of California's Economic Development Allocation is to provide public benefit by creating or retaining permanent private sector jobs, that is, a single job or full-time equivalent job that provides at least 1,750 hours of employment. The eligibility requirement of the State CDBG program under the low/moderate income national objective is that at least 51 percent of the new hires and/or retained employees be persons from the targeted income group (TIG).

<u>If a project will not meet this criteria, but it may meet another National Objective, the jurisdiction should contact HCD for eligibility of the project under that national objective.</u>

<u>Is the Amount of Assistance Requested "Appropriate"?</u> The third test of eligibility of a loan to fund a project for a for-profit business is dependent on an "appropriate" determination to justify the provision and extent of CDBG assistance. The loan administrator can determine whether the amount of CDBG assistance is appropriate by following the HUD underwriting guidelines. The objectives of the underwriting guidelines are to ensure the following:

- that project costs are reasonable;
- that all sources of project financing are committed;
- that, to the extent practicable, RLF funds are not substituted for non-Federal financial support;
- that the project is financially feasible;
- that, to the extent practicable, RLF funds are disbursed on a pro rata basis with other financing provided to the project; and
- sufficient public benefit will be received from the expenditure of RLF funds.

A detailed explanation of the objectives and the procedures that lead to a determination under the HUD underwriting guidelines can be found in Exhibit E, HUD Underwriting Guidelines.

<u>Will the project be feasible under other program requirements?</u> In addition to questions about eligibility, public benefit, and national objective, the business loan is subject to other federal requirements, also referred to as federal overlay requirements. Implementation of these requirements can affect project costs and may affect the willingness of a business to participate. It is important that RLF staff understand all the requirements and be able to explain to the applicant the implications for their project. These requirements include:

- Federal and State labor standards requirements, including the payment of Davis-Bacon wages in some projects;
- Environmental review for each business loan under the National Environmental Policy Act set forth in 24 CFR Part 58;
- Minimization of displacement of persons (families, individuals, businesses, nonprofit organizations, and farms) and relocation assistance when displacement occurs;
- Equal opportunity and Section 3 requirements which require, among other things, targeting contracts and employment opportunities to qualifying persons and businesses; and
- Use of eligible contractors who are licensed and in good standing.

Application of the federal overlay requirements is complex. The RLF should refer to the Grants Management Manual and the cited laws and regulations for a more thorough guidance.

The first two questions regarding eligibility and job creation should be initially answered prior to or during the initial interview with the borrower and supported after complete analysis of the project. This interview and the collected documents begin the loan application process. The question regarding “appropriateness” (which includes project feasibility and the ability to repay the loan) is a more difficult question which requires detailed financial analysis and possibly the collection and review of additional documentation. Eligibility under HUD requirements should be initially assessed and monitored throughout project approval and implementation.

FORMAL APPLICATION PACKAGE

The RLF application form should be as simple as possible, but request all relevant material. Most of the information will have already been discussed in the interview. The RLF application is necessary to prevent misunderstandings by documenting the information in written form. Additionally, the application should contain a list of references and an authorization from the principals for credit checks. The jurisdiction may want to include notification to applicants of conflict of interest statues and potential open records issues. [See Exhibit D for a sample loan application.]

<u>Borrower Creditworthiness.</u> After the application is submitted, but prior to the site visit and detailed financial analysis, the credit investigation commences. References should be checked to determine the borrower's reputation, character and past experience. Credit reports should be reviewed and the industry examined to determine its stability and the company's relative position in the industry.

SITE VISIT/FOLLOW-UP INTERVIEW

If the RLF staff is optimistic that the project can proceed, a follow-up interview should be scheduled; this interview should be conducted at the business location if possible. This is called the site visit. RLF staff should ask for a quick tour of the business and an explanation of the production process. Inventory should be viewed.

The RLF staff should make note of the following during the site visit:

General Observations

- Does the office area appear organized?
- Does the production area appear safe, relatively clean and well organized?
- Do the employees (if any) look busy, content and well trained?
- How well is the plant and equipment currently maintained?
- Is the inventory well organized? Does it look current? Is it well stocked?

Questions for Applicant

- Follow-up on any previously unanswered questions.
- Ask how the new financing will improve operations.
- Ask the owner specific questions regarding the impact of the financing on operations such as building code or permitting requirements.

Once the loan application and supporting documentation is submitted and the site visit has been conducted, staff must complete the Verification of CDBG/RLF Eligibility process which includes detailed financial analysis of the project, company and principals.

At each succeeding level of review, the likelihood that the loan can be made increases. By the time the request reaches the detailed underwriting process, the chances of approving the loan should be fairly high. This is necessary because the time and expense of involved in detailed financial analysis make it unrealistic to underwrite every request.

DETAILED FINANCIAL ANALYSIS

After all information is gathered through the application, site visit and interview, the RLF staff will need to answer the final underwriting question: “Is the amount of assistance appropriate?” In addition to following the procedures under the HUD underwriting guidelines, RLF staff will conduct a detailed financial analysis.

RLF staff should follow the identified procedures in underwriting business loans for potential borrowers. The stages in the analysis process are identified in this section, and can be summarized as follows:

- determine borrowers ability to repay;
- assess available collateral;
- assess business financial health;
- identify loan structure, conditions, and covenants; and
- classify the loan.

By following the critical elements included in this process, the RLF’s level of exposure should be controlled, and the risks involved in making the loans better understood by staff, the LAB, and the other lenders.

Ability to Repay: the First Way Out. All lending rests on the basic underlying proposition that there must be "two ways out" of every deal. Each loan must be repayable from two different sources so that if one source fails to materialize, a second source or “way out” is available to repay the loan. Cash flow from operations is the first way out. The RLF should be a cash flow lender. The cash flow or credit test is the primary indicator of the first way out and determines whether or not the company can repay its loan. If cash flow fails to retire an obligation in an orderly fashion, the second escape route is called upon. Normally, the second way out is the collateral which secures the loan.

A cash flow classification system to identify risk has been developed which categories loans into three classifications: I, II, and III. The first criteria is based on available cash flow. The preferred credit test is very straightforward: a borrower's existing cash flow (after certain adjustments) should be adequate to repay the proposed debt service.

Classification I Loans.

$$\frac{\text{ADJUSTED EXISTING CASH FLOW}}{\text{PROPOSED DEBT SERVICE (p+i)}} > 1:1$$

The adjusted existing cash flow is determined by adding-in or subtracting-out certain items which are impacted by the proposed financing. It is determined as follows:

ADJUSTED EXISTING CASH FLOW
from the business's most recent profit
and loss statement)

Last year's Earnings Before Taxes (EBT)
+ Depreciation
+ Savings in Rent, Officer compensation, or other (if any) savings
- Last year's principal repayment on existing debt
- Increased occupancy costs (occurring as a result of the financing)
- Increased real estate taxes (occurring as a result of the financing)
- Other project related expenses (if any)

Adjusted Existing Cash Flow

The Existing Cash Flow **coverage ratio** is defined as the adjusted existing cash flow divided by the proposed debt service (principal and interest). To achieve a Classification I, the adjusted existing cash flow divided by the proposed debt service, the coverage ratio will be greater than 1:1.

If the adjusted existing cash flow exceeds the proposed debt service, and all the evidence and trends suggest that cash flow will continue to exceed the proposed debt service, in all likelihood, the company is bankable and the RLF will probably approve the deal. In a nutshell, the company will have demonstrated that it's existing operations throw-off sufficient cash flow to repay the proposed borrowings. The company will not have to rely on any growth or outside sources to repay the proposed obligation. This type borrower is given a "I Classification.”

Classification II Loans. Class II loans are based on projections, when existing cash flow does not meet the 1:1 coverage test. Projections are used to demonstrate cash flow, and the projected cash flow is adjusted in a manner similar to the adjustments in the existing cash flow as described above:

PROJECTED CASH FLOW

Projected EBT
\+ Projected Depreciation
\+ Projected interest on proposed loan
\- Principal repayments on existing debt
Projected Cash Flow

The projected cash flow must be greater than the proposed debt service (principal and interest) and the projected cash flow coverage ratio must be greater than 1:1.

$$\frac{\text{PROJECTED CASH FLOW}}{\text{PROPOSED DEBT SERVICE (p+i)}} \geq 1:1$$

In applications where the existing cash flow is not adequate to repay the proposed debt, in addition to closely assessing the reasonableness and achievability of the projected cash flow, the LAB should more closely scrutinize the capability of the company's principals. The principals must demonstrate adequate organizational skills to be able to generate and manage the necessary growth and to increase the profits to the level at which cash flow will be sufficient to repay the proposed debt. Obviously, in situations where existing cash flow is not adequate to repay the proposed debt, the evaluation of credit will be more subjective and less objective.

A borrower who fails to achieve a I Classification, but satisfies the LAB that its projections are reasonable and its principals are solid, will receive a II Classification. Potentially, a company which falls into a II Classification can be upgraded to a I Classification by restructuring the proposed financing (i.e., by reducing the loan amount, changing the maturity of the debt, increasing the equity portion, etc.) so that existing cash flow becomes sufficient to repay the proposed debt service.

Classification III Loans. If a company fails to receive a I or II Classification, it will receive a III Classification. By definition, in III Classification companies, existing cash flow or cash flow based upon a reasonable projection will not be sufficient to repay the proposed debt in an orderly fashion. In other words, there is no first way out. These are very tough deals to finance. The RLF, however, should not automatically decline these deals. Instead, the LAB should look for a surrogate or alternative first way out. A proposed surrogate first way out must be a tangible and identifiable source of repayment with a high degree of reliability. Potential sources of repayment could be outside guarantees, outside income streams, or outside collateral. The collateral of the project and the company cannot serve as an alternative first way out, because it already is being relied upon as the second way out. The RLF should not permit more than five percent of its portfolio to be in loans to III Classification companies.

As is clear from the above discussion, the RLF should have a three-tier cash flow classification system as follows:

CASH FLOW CLASSIFICATION SYSTEM

CLASSIFICATION	**CREDIT TEST**
I	$\dfrac{\textbf{Adjusted Existing Cash Flow}}{\textbf{Proposed Debt Service}} > \textbf{1:1}$ Adjusted Existing cash flow is sufficient to repay the proposed debt service. Management appears capable and sound. In all likelihood this deal will be approved if collateral coverage is sufficient. At least 75 percent of the RLF's portfolio should be Class I.
II	$\dfrac{\textbf{Projected Cash Flow}}{\textbf{Proposed Debt Service}} > \textbf{1:1}$ Projected cash flow based upon reasonable projections, is sufficient to repay the proposed debt service. Management appears capable and sound. It is possible that the company will be able to grow sufficiently to meet its obligations. To approve this deal, a more subjective credit evaluation must occur. At least 95 percent of the RLF’s portfolio should be Class II or higher.
III	**<u>Surrogate First Way Out</u>** The deal does not have a first way out and can be approved only by finding an alternative or surrogate first way out. No more than five percent of the RLF’s portfolio should be in loans to III Classification companies.

The RLF’s Collateral Policies: the Second Way out. The RLF’s second step in underwriting will be to look at collateral coverage. Every loan must have two ways out. The first way out is cash flow. The second way out is collateral. Within reason, the stronger the first way out, the less concerned we need to be about the second way out. In all cases, however, a collateral position must be taken to secure the obligation. While the RLF should be primarily a cash flow lender, the RLF should secure a loan with a general security agreement, a perfected lien on all assets, and the personal guarantees of all principals who own 20 percent or more of the stock or play a key role in management. Because each business is different, few absolute statements can be made regarding collateral.

Regardless of how strong or weak a company's cash flow appears, the LAB must assess the adequacy of the second way out, that is, the collateral being offered to secure the loan. Collateral value is not the same as the fair market value of the real or personal property offered as collateral because the time and cost of liquidating the collateral will cause the net proceeds to be less than the hypothetical fair market value of the collateral. For example, real estate is the least liquid of all collateral and costs the greatest to hold. If the RLF were to foreclose on a piece of real estate, the RLF would be responsible for insuring the property, paying the utilities, property taxes and operating expenses during the holding period, and paying a broker or liquidator a commission for disposing of the property. Attorneys would also have to be paid. In all likelihood, the net proceeds from the sale of the property will be less than the appraised fair market value.

In the case of machinery and equipment (M&E), foreclosure on M&E normally involves an auction or liquidator who sells the collateral for a price far below fair market value in order to liquidate the collateral quickly and to allow for the cost of removal from one site and the installation at another site. Finally, regarding receivables and inventory, the collateral value of these assets are far less than their costs or face amount because when a company is in trouble, inventory disappears and receivables are either used by the entrepreneur to fund losses or to pay other, more pressing, creditors. For these reasons, determining collateral value is more involved than simply adding up the cost or appraised value of a group of assets.

The RLF should develop a second classification system that reflects collateral values in relationship to the loan amount. Loans can be classified A, B, or C, depending upon their collateral coverage ratio. This classification can be used in conjunction with the Cash Flow Classification.

Needless to say, the LAB should not be inflexible in its interpretation of collateral value nor rigid in its insistence on 100 percent collateral coverage. Obviously, a strong I Classification company with less than 1:1 collateral coverage should stand a very good chance of being approved.

The following are guidelines which the LAB may use in assessing collateral value.

COMMERCIAL REAL ESTATE: 80 PERCENT OF VALUE

If the RLF receives a first lien on a piece of commercial property, the collateral value of the property will be 80 percent of the fair market value of the property as determined by an objective, outside appraisal. If the RLF takes a mortgage on a piece of property on which there is a preceding lien, the collateral value of the property will be 80 percent of the fair market value of the property less the amount of preceding lien.

RESIDENTIAL REAL ESTATE: 90 PERCENT OF VALUE

If the RLF receives a first lien on a piece of residential property, the collateral value of that piece of property will be 90 percent of the fair market value of that piece of property as determined by an independent, outside appraisal. If the RLF takes a mortgage on a piece of residential property on which there is a preceding lien, the collateral value of the property will be 90 percent of the fair market value of the property, less the amount of the preceding lien.

MACHINERY AND EQUIPMENT: 70 PERCENT OF VALUE

If the RLF receives a first lien on a piece of machinery and equipment (M&E), the collateral value of that piece of M&E will be 70 percent of the fair market value of the M&E. Fair market value can be determined either through independent appraisal or through an estimate from a reputable equipment dealer who opines as to the economic life of the asset, the cost when new, and the value of the specific piece of equipment being offered as collateral. If the M&E has a preceding lien, the collateral value of the M&E will be 75 percent of the fair market value, less the preceding lien.

INVENTORY AND RECEIVABLES:
From a collateral value perspective, receivables will have a collateral value equal to 60 percent of the face amount of the receivables (less than 90 days old) and inventory will have a collateral value equal to 40 percent of cost. Should a borrower get into trouble, the entrepreneur retains full control of the inventory and receivables and uses them in the manner he/she sees fit until foreclosure proceedings are begun. Not surprisingly, inventory and receivables "disappear." In reality, inventory is simply sold and receivables are collected and used to fund losses or satisfy more pressing creditors (e.g., the inventory supplier who is threatening to stop shipments, an insurance company who is threatening to cancel necessary coverage, the IRS who is threatening seizure, or employees who have to be paid at the end of the week). Thus, the collateral value of inventory and receivables to a term lender like the RLF is highly suspect. In spite of this fact, the RLF may accord to inventory and receivables, respectively, a collateral value equal to 60 percent and 40 percent due to the desire to assist businesses.

Classification A Loans. The strongest loans will have a collateral value coverage of the loan amount based upon the criteria described above:

$$\frac{\textbf{COLLATERAL VALUE}}{\textbf{LOAN AMOUNT}} \geq \textbf{1.15:1}$$

Classification B Loans. Slightly below Classification A loans will fall loans with a collateral value coverage between .9 and 1.15 of the loan amount based upon the criteria described above:

$$\frac{\textbf{COLLATERAL VALUE}}{\textbf{LOAN AMOUNT}} \geq \textbf{.90:1}$$

<u>Classification C.</u> The weakest loans from a collateral standpoint will have a collateral value coverage less than 90 percent of the loan amount based upon the criteria described above:

$$\frac{\textbf{COLLATERAL VALUE}}{\textbf{LOAN AMOUNT}} < .90:1$$

THE LOAN REPORT

The loan report should be written so that it can be understood both by those familiar with lending and underwriting criteria and those unfamiliar with such topics. Lenders will inevitably focus on the hard financial data; business professionals tend to focus on marketing and management; economic development professionals tend to focus on the jobs; and state and federal officials view the report as documentation that the appropriate determination has been conducted and that the determination is reasonable. The loan report must satisfy all these interests and attempt to answer the majority of questions that members of the LAB are likely to ask about the project. The report should be delivered to the members of the LAB in advance of the meeting to allow sufficient time for each member to review the request at their leisure. Members of the LAB should be encouraged to call the RLF staff and ask questions prior to the meeting. This will help the RLF staff to prepare for the “oral presentation” of the loan report which should include the answer to any questions that have been raised.

The loan report prepared by the RLF staff should include at minimum the following information:

- Borrower’s name, address, telephone number and legal structure
- Principal’s or owner’s name, address, telephone number and percentage of ownership;
- Brief summary of business and project;
- Description of financial condition of the business, historical trends, ability to repay proposed loan, collateral offered and the capabilities of management;
- Analysis of project under HUD’s underwriting guidelines and determination of appropriateness of amount and terms of CDBG assistance and of sufficient public benefit (number of jobs for CDBG funding);
- RLF staff’s recommendation; and

- Amount, terms and conditions of the proposed loan

Additional attachments may include:

- Spread of historical financial statements;
- Financial statements of the business;
- Personal financial statements;
- Credit reports (business and personal); and
- Appraisal or another form of collateral valuation.

A copy of the loan report should be delivered to the Loan Advisory Board at least two to three business days before the scheduled meeting. [See Exhibit D for a sample loan report and oral presentation format].

Loan report and application evaluated by Loan Advisory Board. The Loan Advisory Board should discuss the application candidly. Any potential conflicts of interest between a member of the LAB and the applicant should be stated prior to the beginning of any discussions regarding the application in question. The LAB should base its decision to approve or reject an application on its assessment of the adequacy of cash flow, the sufficiency of collateral, the capability of management, the overall soundness of the proposal, and the appropriateness of the CDBG assistance under HUD underwriting guidelines, including the adequacy of the public benefit in the form of new or retained jobs. For example, a company with a I Classification (i.e., an application in which existing cash flow exceeds proposed debt service) is a good indication of strong management. With a high probability that the first way out will be sufficient to repay debt, the I Classification company need meet only minimum collateral requirements. An application from a II Classification company, with its first way out being sufficient only if growth occurs and profits rise, will require closer analysis. The LAB's evaluation of management should be more in-depth and the adequacy of collateral should be stricter. An application from a III Classification company should require a close look at the surrogate first way out and the most studied evaluation of management. Such a loan should be well collateralized.

The RLF should not be a formula lender; it should employ ratio tests such as debt-to-equity ratio, current ratio, quick ratio, or an asset turnover ratio in making its credit decision only as a technique for identifying possible issues that need further analysis. This does not mean that the LAB will not analyze the adequacy of working capital or equity when it reviews an application. If debt is too high relative to equity, it is unlikely that the collateral will be adequate or that cash flow will be sufficient to repay all obligations in a timely fashion. If working capital is too thin, it is unlikely that growth will occur to increase profits. Thus, while the RLF should not employ ratio tests in making its credit decision, it should analyze the adequacy of working capital and equity in determining if cash flow is achievable and collateral is sufficient.

Members of the LAB may question the structure or terms of the proposed loan. They may offer suggestions. Often these issues have already been considered by the RLF staff prior to meeting with the LAB. Staff should inform the LAB of the reasons why a particular structure or term was rejected. On the other hand, the LAB may propose something which the RLF staff has not considered. Members of the LAB should be willing to lend their credit and business experience to the process. The LAB should not be a “rubber stamp” board, nor should it look for creative ways to turn deals down. The purpose of the LAB is to support the RLF staff in making loans to businesses which have a high probability of success.

At the conclusion of the LAB meeting the board may take any of the following actions:

- Defer the application until the next meeting. This usually occurs when a crucial question is left unresolved;
- Reject the application. Typically the application is denied for underwriting or eligibility reasons;
- Restructure the proposal and refer it back to the applicant for further consideration. If the LAB suggests a different term, interest rate, equity injection, or lien position, the applicant will need to agree to any changes proposed by the LAB; or
- Refer to the City/County staff with recommendation for approval.

Notification of Applicant. Whether the LAB approves the project as structured, recommends an alternative structure, or declines the request, the applicant should be notified in writing of the LAB’s decision. If the request is approved, the terms and conditions of the loan should be included in a formal commitment letter. If denied, the reason for the denial should be included in the letter. Staff is advised to have legal counsel review both commitment and denial letters to ensure compliance with all applicable laws and regulations concerning administration of the program. [See Exhibit D for sample letters]

V. CLOSING THE LOAN AND DISBURSING FUNDS

Closing an RLF loan consists of several steps:

- Commitment letter review;
- Document preparation;
- Closing the loan; and
- Disbursement of funds.

The process should be as streamlined as possible. This includes using standardized loan documents when possible. Prior to use by the jurisdiction, all loan documents, including those provided as examples in this manual, should be reviewed by an attorney familiar with economic development lending.

Commitment Letter Review. The commitment letter will detail the terms and conditions of the RLF loan. Terms may include the commitment of other private sector lenders or private investors to the project. Once all sources of funds have been formally committed to the project, a pre-closing conference is often helpful. The closing conference (whether by phone or in person) should cover the requirements and timing for closing each loan.

Document Preparation. Closing the private sector loan is the responsibility of the private sector lender. The RLF staff may assist by helping the applicant gather the information required by the private sector lender. Closing the RLF loan is the responsibility of the RLF staff and their attorney. A comprehensive checklist of closing documents and whose responsibility it is to prepare or obtain these items should be drafted. The lender and RLF closings may occur separately or together.

An intercreditor agreement which clearly states the lien positions of each lender to the project should be drafted prior to the scheduled closing. This should help prevent disagreements at the closing table and provide for a timely closing. An intercreditor agreement commits each lender to notify the others in the event of problems and outlines other special arrangements between the lending parties.

Closing Documents. Prior to disbursement of funds for a direct loan, proper loan documentation should be reviewed by the RLF staff and their legal counsel.

In general, the closing documents will include the following:

a. Articles of incorporation and bylaws, or partnership agreement
b. Corporate resolution to borrow, or partnership agreement and authorization for borrowing
c. Borrower's opinion of counsel (that business is a legal entity entitled to borrow and has no pending litigation)
d. Bank commitment letter
e. Loan agreement
f. Subordination agreement (if needed)
g. Closing statement
h. Promissory note
i. Security agreement for personal property such as machinery, equipment, inventory and accounts receivable. This must be perfected with the secretary of state and/or county court, if applicable.
j. Uniform Commercial Code (UCC) statements and UCC lien search
k. Mortgage and deed of trust, if applicable. This must be filed with county recorder.
l. Personal guarantee(s)
m. Corporate guarantee(s) (where appropriate due to common ownership, management or control)
n. Appropriate hazard insurance (fire, theft, hazard) and life insurance payable to lender
o. Title insurance, insuring the RLF in the amount of the loan against liens which have not been accepted
p. Intercreditor agreement (if needed)
q. Certificate of good standing
r. Evidence of equity commitment
s. Seller's note (if needed)
t. Lien waivers (if construction is involved)
u. Employment agreement

The loan closing process is not complete until the borrower has submitted all the required documents. Public funds should not be disbursed until all documentation has been submitted and reviewed. The loan closing checklist should be used to confirm that all the required documents are in hand. The completed documents should be reviewed by an attorney representing the RLF prior to execution. Although the documentation process may have been standardized, changes made to a document to facilitate a particular borrower's needs may affect the legality or intent of the document. The attorney should be made aware of any such changes prior to closing.

Attorneys familiar with general lending practices may have little experience with the specific program requirements of the State of California and HUD. In addition to informing the attorney of any changes made to the loan documents, RLF staff should also review the documents to ensure that all requirements of the RLF program have been met. This should include compliance with the State's and HUD's rules and regulation governing the use of CDBG funds for an RLF (e.g., environmental review, Davis Bacon, and public benefit). The RLF lender should refer to the State's Grant Management Manual for additional information regarding these issues, and any questions should be discussed with the appropriate staff in the HCD office at the State prior to closing.

Filing Documents. Once all documents have been executed, careful follow-up is necessary to confirm that all the required filings were completed and are accurate (e.g., deed of trust filings in the county real estate records and UCC filings).

Disbursing Funds. The RLF should develop a formal loan disbursement process to ensure that funds are disbursed in accordance with the loan agreement, in compliance with HUD requirements, and consistent with prudent lending practices. Key components of a disbursement process include:

- Pro rata disbursement;
- Safeguards for ensuring funds are disbursed when needed for intended purpose;
- Accurate and complete recordkeeping; and
- Retention policy.

A term sheet should detail how funds will be disbursed. In most instances, equity will be disbursed prior to CDBG funds. This will be included by the particular use of funds in the project. HUD guidelines require, to the extent practicable, that RLF funds be disbursed on a pro rata basis with other lenders. Generally, funding draws from each source will be in the same proportion as the total funds available from each source. This helps to ensure that the risk is spread throughout each phase of the project and that the CDBG funds are not placed at undue risk.

The disbursement process should provide safeguards to ensure that funds are disbursed when needed for their intended use [See Exhibit H, HUD Guidance on Disbursement of Funds for Economic Development Loans.] Draws should be limited to the amount needed and timed with project requirements. For example, if a loan is made for working capital, the amount of the draw would depend on the working capital needs of the business for the next 30 to 60 days.

Disbursements should be supported by appropriate documentation to ensure that funds are used for their intended purpose and that costs were actually incurred and are valid. For example, a co-payment check to a contractor will protect the lender and the borrower, as well as the contractor. Costs should also be verified to ensure that costs have not been inflated and that the collateral is worth its stated value.

It is recommended that the RLF’s disbursement process include a policy of retention for construction projects. The policy should establish a percentage of each draw which will be withheld until completion of the project and until other terms and conditions have been met. Release of the retention may be conditioned on such things as: sign off of the punch list items by the project architect and local inspector; clearance of permits; recording of notice of completion; and title insurance policy endorsements evidencing lien-free completion.

VI. LOAN SERVICING AND MONITORING

When a loan is closed, the RLF enters into a long-term relationship with the borrower and must make a corporate and personal commitment to protecting that relationship. In order to keep that relationship in good standing, the RLF should develop a servicing system that allows staff to anticipate problems and to help solve them.

Loan servicing begins immediately after the closing, and continues for the term of the loan. RLF lenders typically go “above and beyond” conventional lenders in making loans, and RLF lenders should be prepared to go “above and beyond” conventional servicing procedures in servicing their loans. The RLF lender must be proactive to ensure the continuing viability of the portfolio. Prudent loan servicing should be one of the RLF’s top priorities.

There are four major roles for the RLF lender in servicing a loan portfolio; the four areas are as follows:

- Billings and collections
- Ongoing portfolio management and annual review
- Managing delinquencies and workouts
- Reporting results

BILLINGS AND COLLECTIONS

Although the Promissory Note itself can serve as notice of payment, the RLF lender should consider sending a monthly notice or providing the borrower with a coupon book to alert them that a payment is due. If a third party is performing this service, the RLF lender will need to verify the results through payment records provided by the third party. Depending on the size of the portfolio, this review may need to be done as frequently as daily. If review is done on a monthly basis, a borrower could be delinquent thirty days before the RLF lender even knows there is a problem. Once a borrower gets behind a full payment, it can be difficult for them to catch up. At minimum, weekly review is recommended.

One way to simplify the billing and collection process is to require all payments be due on the same day (e.g., the first of the month). If all payments are collected by the tenth of the month, no review will be required until the following month.

If the RLF guarantees another lender's loan, servicing the loan is the responsibility of the private sector lender, but the RLF must be kept properly informed of the status of the loan. The guaranty document should specify the notification procedure. In any case, the RLF lender should not give up the power of negotiating workouts should the guaranteed loan become delinquent.

ONGOING PORTFOLIO MANAGEMENT

Each loan in the portfolio should be assigned to one RLF staff person for effective servicing. It is usually preferable to assign the task to the staff who handled the loan through closing and disbursement; this person has more at stake - it's his or her loan. This approach leads to greater care and consistency in managing the loan. Ongoing portfolio management should include a review of payment history, the status of collateral and adherence to loan covenants and an annual review.

Purpose of the Annual Review. The purpose of the annual review is to:

1) Determine if there has been a change in a Borrower's financial position which could affect future loan repayment ability;

2) Determine if there has been a violation of any loan covenant;

3) Determine if there has been any material change in the collateral and guarantees securing the RLF loan;

4) Provide an opportunity for comprehensive analysis (and reclassification, if appropriate) of a borrower who has received RLF funding; and

5) If necessary, provide a platform from which a plan can be developed (with the borrower, the RLF and the private sector lender) which will address or remedy any outstanding deficiencies found in one through four above.

Annual Review Process. The optimum time for an annual review is 60 to 90 days after the end of the borrower's fiscal year, since the borrower's financial statements and tax returns have usually been completed by this time. The process involves the following steps:

- Collecting financial statements and information (year end financial each year, and updated personal financial statements for every principal and/or guarantor every two years);
- Performing updated personal and corporate credit checks (every two years, unless there has been some intervening problem with the borrower, in which case they should be run every year);
- Spreading financial information, checking analysis information and monitoring results against loan covenants (looking for signs of dangerous deterioration of sales or loss of management control, and checking for loan covenant violations);
- Performing a site visit to interview the borrower, check collateral, and review preliminary analysis of spreads;
- Preparing and receiving annual borrower certifications regarding job creation, operations and loan covenants;
- Analyzing the data, the spreads, and preparing an annual report [see Exhibit B];
- Assigning an updated classification to the loan, based on the quality of the findings [see Exhibit B];
- Developing an action plan with the borrower (and private lender(s)) to correct deficiencies, if necessary; and
- Reviewing the annual report, revised classification and corrective action plan with the Loan Advisory Board.

Curing Loan Documentation Deficiencies and Violations of Loan Covenants. If during the review process, it is discovered that an original piece of loan documentation securing a loan is missing from a legal file, an identification must be made of the missing document and the appropriate steps should be taken to correct the problem. However, it is very difficult to correct this type of problem once a loan is booked. The RLF lender will not be able to get a guarantor to sign a guarantee again because an original document was misplaced, or a borrower to sign a Note because it was lost. Staff must make sure that loans are properly secured at the outset and that legal documentation is stored securely. RLF staff should not be permitted to hold on to original legal documentation in their desks or in credit files.

Too many loan covenants mean most of them may be waived. This can be avoided by keeping to the basics, e.g., no dividends or withdrawal, no additional borrowings without prior consent. Don't create a list which cannot be enforced and will wind up being waived. However, those covenants which are basic to the strength of the credit should be enforced.

An annual review is a meaningless process if it doesn't help the RLF staff manage the loan portfolio better. The net result of the analysis has to be to get staff focused on taking corrective action to remedy a problem. It is this corrective action which may prevent a loan from going into irreversible default, thereby losing the community's investment.

RLF lenders will be able to handle some corrective actions on their own. Others may require the help of legal counsel. There is no "one" solution to a problem. Each problem is unique and will require special attention. There are also no time guidelines. It can take one month, four months, six months, depending on the issues and the personalities involved. At the outset, staff must evaluate the following:

- Is the problem the borrower is experiencing temporary or permanent?
- Can this situation be salvaged (remember the priority is to preserve jobs and taxes, not to act as a liquidator)?
- What legal remedies does the RLF have?

Make sure to take the time to detail the action plan and the steps needed to achieve the desired results. Set deadlines. Review the plan biweekly and revise accordingly. Stay on top of the situation.

The "Tickler" System. To facilitate the collection of data, the RLF should create a centralized "tickler" system. The system should be organized by month, when items are due and anniversary date of each loan. The "tickler" system may be maintained on computer or by hand. It should include the following information:

- life insurance premium payment due date;
- hazard insurance premium payment due date;
- property tax due date;

- updates of personal financial statements;
- updates of annual financial statement for the Borrower;
- biannual financial statements of guarantors;
- Uniform Commercial Code (UCC) renewal dates

If the RLF staff consist of more than one person, the "tickler" system should be assigned to and managed by one individual to ensure consistency and accountability. This individual should be responsible for collecting the data and reminding RLF lenders of deadlines.

MANAGING DELINQUENCIES AND WORKOUTS

A defined policy and written procedure to deal with delinquent and other "problem" loans is important. The RLF lender must be kept informed of the status of all loans for which he or she is responsible for collecting. It is advisable to meet with other participating lenders early in the process to discuss possible courses of action and to gain their support. Depending on the situation, a variety of possible solutions can be examined to remedy temporary problems. Possible workout strategies should include the following:

- Extending the loan term to lower payments;
- Lowering the interest rate to lower payments;
- Deferring interest or principal for a specified period;
- Refinancing to adjust payment terms to better meet Borrower's needs; and
- Financing other needs of the company such as working capital or additional equipment.

Finding an equitable solution is absolutely preferable to foreclosure. In the final analysis, the RLF is trying to determine what the community would lose if the loan was forgiven or if the business failed. The RLF should seek a solution which meets the Borrower's needs and solves the deficiency problem. The ultimate goal of a workout strategy is to be repaid in full while still maintaining the jobs and the tax base for the community.

REPORTING RESULTS

A system for regularly reporting on the results and successes of your RLF program should be developed. This should include monthly updates to the Loan Advisory Board and city or county administrators on the payment status of all loans, and the action being taken to remedy the problems on all delinquent accounts. Reports on job creation and other compliance items should be reported as often as necessary and, at minimum, semi-annually since the State requires a semi-annual and annual report on loan activity, as well as public benefit and national objective outcomes.

An annual report on the entire RLF portfolio should be prepared. This should include loan repayment history, loan covenant compliance, job creation data and other relevant facts. This can be a valuable tool for demonstrating the success of the RLF. State CDBG reporting requirements also necessitate the ongoing collection of portfolio information [See Grants Management Manual, Chapter 10 for report forms.]

STATE OF CALIFORNIA
Department of Housing and Community Development
Community Development Block Grant Program
Economic Development Allocation

REVOLVING LOAN FUND HANDBOOK

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Prepared by:
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and
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